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Devolution Criteria : From Gamble to Policy

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Introduction

On Centre-State fiscal issues, the publication of the Eighth Finance Commission's report (July 1984) provides fresh grist to the mill. The focus of this paper is limited but central. The attempt is to suggest a procedure for devolution that could establish a coherent policy framework for the coordinated functioning of Finance Commissions and the Planning Commission based on an evaluation of the criteria for devolution adopted by successive Finance Commissions including the Eighth.

Under Article 280 of the Constitution, Finance Commissions have the responsibility primarily to recommend on (a) the distribution between the Union and the States of the net proceeds of taxes which are to be, or may be, divided between them (b) the allocation between the States of the respective shares of such proceeds and (c) the principles which should govern grants-in-aid to the States from the Union. The taxes which "are to be" shared are taxes on income other than agricultural income (Article 270); those which "may be" shared are Union duties of excise (Article 272); under Article 275, States which are "in need of assistance" are eligible for grants-in-aid. By devolution criteria, we mean the criteria adopted by Finance Commissions for recommending transfers to the States under Articles 270 and 272 (i.e., tax-sharing) and under Article 275 (grants-in-aid).

Finance Commissions also make recommendations on other matters referred to them by the Union Government "in the interests of sound finance" (Article 280 (3) (c)). Such other matters included in their terms of reference have related to the sharing of additional duties of excise <u>in lieu</u> of sales tax, estate duty in respect of property other than agricultural

land, grants in lieu of the tax on railway passenger fares, and grants on account of wealth tax on agricultural property. These are basically tax-rental arrangements and do not raise the kind of issues involved in devolution under Articles 270, 272 and 275. In addition, the advice of the Finance Commission has been sought on such matters as the financing of relief expenditure on natural calamities, debt accommodation (i.e., non-plan capital gap), raising of resources under Articles 268 and 269, and the upgradation of standards of administration. These are important issues but they too fall outside our present concern.

It is important to give undivided attention to devolution criteria for two main reasons. Devolution accounts for the very large bulk of transfers made by Finance Commissions under all heads, an estimated 85 per cent under the VIII Commission. Secondly, while broad commonsense considerations have been found sufficient to deal with tax-rental arrangements, relief expenditure, debt accommodation, and upgradation of standards, a long-term framework is necessary to settle devolution criteria and to coordinate such criteria with the operations of the Planning Commission in the federal-planning context of India. Over more than three decades (1952-84) eight successive Finance Commissions have failed to develop such a framework.

Justice P.V. Rajamannar, the distinguished Chairman of the Fourth Finance Commission (1965), drew attention to the issue in forceful terms in a personal minute that he appended to the report of that Commission.[1/]

> "As regards distribution inter se among the several States, the general principles and criteria may be laid down in the Constitution. Here again, there has been a great divergence in the suggestions put forward by the States before the Finance Commissions. Population, contribution, collection, relative financial weakness, social and economic backwardness, per

> capita income are some of the different criteria urged by one or other of the States. In respect of such an important matter as the determination of the resources which will be available to each State as a result of a scheme of devolution, there should not be a gamble on the personal views of five persons, or a majority of them." He went on to add: "I say this without intending any disparagement of the eminence, equipment and impartiality of the Members of the Commissions".

The substantive issue raised by Justice Rajamannar is that firm criteria should be evolved for devolution without leaving the matter to the outcome of a quinquennial gamble: whether such criteria should get located in the Constitution is a different and debatable issue.

The attempt in this paper will be to suggest the general principles that would seem to be appropriate for devolution and a practical procedure that could put such principles into operation. We shall confine our attention to the 15 major States in India. They all have populations of more than ten million and their combined population is 97.6 per cent of the population of all 22 States. The remaining 7 states viz., Himachal Pradesh, Jammu and Kashmir, Manipur, Meghalaya, Nagaland, Sikkim and Tripura are in a special category on account of size, location and terrain. They have to be dealt with separately as they do not admit of bring brought within the ambit of "general" principles. We shall use the data available in the VIII Finance Commission's report to illustrate our argument. It shall be assumed for purposes of the analysis that quinquennial award periods of Finance Commissions are co-terminus with Five Year Plan periods.[2/]

The subsequent part of the paper is divided into three broad sections. The first section contains an evaluation of the criteria used by successive Finance Commissions and currently by the Planning Commission in mediating resource

transfers from the Centre to the States. Based on the critique in the first section, the second explores the lines along which a practical and logical approach could be evolved for devolution. The third section seeks to translate this approach into a devolution formula that could be adopted by Finance Commissions and proceeds to sketch a complementary policy for plan transfers.

I

The Two Commissions

We may begin by noticing that the Constitution itself does not provide any guidance on the criteria to be applied for arriving at the aggregate transfer from the Centre to the States ("vertical" sharing) or for the distribution of the aggregate amongst the States ("horizontal" sharing). No minimum percentage is set on income-taxes which "are to be" shared under Article 270; nor a maximum prescribed in the case of Union excise duties which "may be" shared under Article 272. Grants-in-aid are to be recommended under Article 275 for States "in need of assistance" but there are no Constitutional guidelines for assessing such needs. From occasion to occasion, Finance Commissions have thus been entirely free to develop their own criteria to determine the basis for both vertical and horizontal transfers. The Constitution itself has not placed any constraints, nor provided any guidance, in these matters.

The Constitution also does not restrict the end-uses to which the Finance Commission may direct its transfers. They could be used for covering revenue or capital expenditures and for developmental or non-developmental purposes. When the Constitution was adopted in 1949, the planning process had not been initiated and the Planning Commission had not come into being. Centre-State transfers were envisaged as

taking place mainly under the aegis of the Finance Commission. Even after the Planning Commission entered the picture in 1951, there was an initial period of ambiguity. But since the IV Finance Commission (1965), a division of responsibility has come to be established in practice between the Finance Commissions and the Planning Commission.[3/] Under this, Finance Commissions direct their transfers, in the form of shared taxes and grants, to cover the gap on the non-plan revenue account of the States while Central assistance for the Plan, in the shape of loans and grants, goes towards meeting incremental developmental expenditure.

It is important to recognise that in the planning framework this two-step procedure, which inter-connects the operations of the two Commissions, is functionally necessary. In as much as the Plan implies incremental expenditures, any shortfall (or gap) on the non-plan account that arises from an inadequacy of current revenues to meet established and continuing prior commitments will first have to be made good before additional expenditures arising from the plan can be undertaken with additional resources being raised for them. In other words, the decks will have to be cleared for plan financing and this what the Finance Commission seeks to do.

The burden-sharing of the two Commissions also has its dynamic aspect. As development proceeds, there is a steady increase in current, or revenue-account, expenditures required for the continuation or maintenance of services and facilities progressively created in earlier plan periods. Much of so called "non-plan" expenditures in the States' sector - about 70 per cent - are committed developmental expenditures of this kind. The second important component of non-plan revenue expenditure consists of interest which is a function of debt incurred for financing development expenditures under the Plan; as development proceeds, the interest burden also increases. Thus non-plan revenue expenditures, principally on maintenance and

interest, increase *pari passu* with successive Plans; and so does the Finance Commission's role in meeting them. This is illustrated by the fact that the Finance Commission's share in overall Centre-State transfers has increased from about 34 per cent in the First Plan period to nearly 45 per cent in the Sixth.

Devolution criteria adopted by Finance Commissions

In seeking to evolve criteria for vertical and horizontal transfers that will cover the non-plan revenue gap of the States, Finance Commissions have had to face procedural and policy issues. To start with, they have had to "standardise" the projections made by State governments by using technical judgements in regard to rates of growth for revenues and expenditures, normative judgements on rates of return that the States could reasonably be expected to earn from investments such as on power, irrigation, road transport undertakings and industrial ventures, and in providing for expenditures to upgrade standards of administration in such matters as police, jails, courts and so on and, where necessary, for upgrading emoluments of employees. We shall not go into the problems raised by these procedures for "assessing" the gaps except to note that the Finance Commission only purports to cover assessed gaps and not the actual ones presented by State Governments; and that the process of assessment introduces built-in elements premised on the achievement of economy, efficiency and upgradation.

As pointed out earlier, the requirement that arrangements should be made to cover, at the beginning of quinquennial plan periods, the assessed gaps on the non-plan account is inherent in the division of responsibility that has come to be necessarily established between the Finance Commission and the Planning Commission. One course of action could have been to use devolution only to meet such gaps in the case of deficit

States and no more. In that case, the horizontal shares will be the same as the gaps, the vertical transfer will be the sum of such shares, and States which have a surplus position on the non-plan revenue account prior to devolution will not obtain any transfers. Finance Commissions have not followed such a minimalist approach but have viewed the process of transfers as entailing the evolution of principles or criteria for transfers rather than one of determining the amounts of transfer, leaving the amount for each State to result from the application of the criteria chosen.

Criteria for horizontal tax sharing

Each of the eight Finance Commissions has used its own criteria for horizontal transfers. Criteria have also differed between income taxes and Union excise duties. For the sharing of income taxes, the first seven Finance Commissions have used population and contribution (i.e., collections in the State) as determinants for transfer with the respective ratios varying between 80:20 (I, III and IV Finance Commissions) and 90:10 (II, V, VI and VII Finance Commissions). In regard to excise duties, the first six Finance Commissions have used population to determine 75 per cent or more of transfers from this source. In regard to the balance of transfers from excise duties, practice has diverged. The III, IV and V Finance Commissions used criteria linked to specific characteristics of economic backwardness or advancement such as agricultural output, industrial output, work-force participation, school enrolment, hospital bed-population ratio, rural population, population of scheduled castes and tribes, irrigated area, and availability of railways and surfaced roads. The VI Finance Commission explicitly rejected the approach of using specific indicators for assessing economic backwardness in excise transfers.4/. It gave a weight of 75 per cent for population and distributed 25 per cent on the basis of the State's per capita income from

that of the State with the highest per capita income (the distance criterion). The VII Commission drastically reduced the weight for population to 25 per cent. For the balance it gave equal importance (i.e., 25 per cent in each case) to criteria based on (a) the inverse of the per capita State Domestic Product (b) the percentage of the "poor" and (c) a revenue equalisation formula which purported to take into account the relative tax effort of States. The last of these in effect boiled down to the distance criterion on account of the methodology used for 'revenue equalisation'.[5/]

The VIII Finance Commission has continued to give a weight of 10 per cent for collections in income-tax sharing. It has used a common formula for the balance of income-tax and for the whole of excise transfers. This uses population for 25 per cent of tax sharing, the inverse of per capita income for 25 per cent and the distance criterion for 50 per cent.

Table 1 sets out in one place the transfer criteria used by all eight Finance Commissions for tax-sharing under Articles 270 and 272. No two Commissions have used the same formula. Nor can any orderly evolution be read into the varying practices of different Commissions. However certain trends can be noticed:

(a) Until the VIII Finance Commission, income-taxes have been allocated on an entitlement basis using population as the major criterion and collections as a minor criterion. Neither of these criteria are redistributive in the sense of giving larger shares to the "weaker" States. Population as a criterion distributes unit shares per capita in all States. It is a uniform scaling factor i.e., a distributive rather than a redistributive yardstick. 'Contribution' relatively benefits the more developed States in which there is greater tax-origination by virtue of a better income-base.

Table 1: Criteria for tax-sharing used by Finance Commissions

(percentages)

Commission (award period)		Income Taxes		Excise				
		Population	Contribution	Population	Specific indicators	Aggregate indicators 1/		
						Inverse	Distance	Poverty
First	(1952-57)	80	20	100	-	-	-	-
Second	(1957-62)	90	10	90	10	-	-	-
Third	(1962-66)	80	20	2/	-	-	-	-
Fourth	(1966-69)	80	20	80	20	-	-	-
Fifth	(1969-74)	90	10	80	20	-	-	-
Sixth	(1974-79)	90	10	75	-	-	25	-
Seventh	(1979-84)	90	10	25	-	25	25 3/	25
Eighth	(1984-89) 4/	-	10	25	-	25	50	-

1/ 'Inverse' and 'Distance' are with reference to per capita SDR.

2/ The Third Commission did not specify its exact formula beyond saying that 'population was the major factor'.

3/ The revenue equalisation formula was in effect the distance criterion.

4/ The formula for excise-sharing was also used for 90 per cent of income taxes.

(b) On the other hand, there has been a tendency to use redistributive criteria for excise-sharing, although up to the VII Finance Commission (1978), the use of such criteria has been secondary with population being used as the major determinant for excise-sharing as well.[6/] It is the two most recent Finance Commissions which have shown a distinct shift to redistributive criteria: the VII Finance Commission (1978) in the case of excise-sharing and the VIII Finance Commission (1984) in their substantial use for both taxes.

(c) It is economic backwardness rather than fiscal weakness that has sought to be taken into account for the purpose of redistribution. Since the VI Finance Commission (1969), there has been a shift from specific to aggregate indicators, mainly based on the per capita SDP, for measuring such backwardness.

Vertical tax sharing

Vertical tax sharing has not been determined according to criteria but on the basis of the judgment of the Finance Commissions of the relative needs of the Centre and the States on each occasion. The extent of taxes ahred with the States has increased over time : from 55 to 85 per cent in income-taxes and from 20 to 40 per cent in Union excise duties. The income-tax proportion reached 85 per cent with the VII Commission (1978) and has remained at that level with the VIII Commission (1984). The excise proportion remained at 20 per cent between the III (1961) and the VI (1973) Commissions. The VII Commission effected a quantum increase by doubling it to 40 per cent and the VIII Commission has marginally increased it further to 45 per cent.

Article 275 grants-in-aid

The First Finance Commission (1952) recommended certain principles such as budgetary needs, tax effort, economy in expenditure, standard of social services, special obligations

and broad purposes of national importance for determining the quantum of grants-in-aid under Article 275 to the States.7/ In practice, however, successive Finance Commissions have used Article 275 grants as a residuary instrument to fill the remaining gap after taking into account tax sharing under Articles 270 and 272. In other words, the consideration of 'budgetary needs' has become over-riding. The extent to which gap grants under Article 275 have been used has depended on the extent of vertical tax sharing under Articles 270 and 272 in the devolution process. With a substantial resort to the latter under the VII and VIII Finance Commissions, the proportion of Article 275 gap grants in overall devolution has sharply decreased as Table 2 will show.

Plan transfers

Central plan assistance to the States is provided in terms of both grants and loans. For all States, the ratio of grants to loans is uniformly 30:70. In the Sixth Plan, one part of Central Plan assistance to the States (Rs.2805 crores or 18.3 per cent of the total) was reserved for hill areas and tribal development, States in the Northeastern Council and for States implementing externally-aided projects. A second part (Rs.3245 crores or 21.1 per cent) was kept aside for special category states viz., Assam, Himachal Pradesh, Jammu and Kashmir, Manipur, Meghalaya, Nagaland, Sikkim and Tripura. The balance of 60.6 per cent was allocated on the "modified Gadgil formula" adopted by the National Development Council in 1980. According to this formula, the shares are determined in terms of (a) 60 per cent according to population (b) 20 per cent to States having per capita incomes below the national average (c) 10 per cent on the basis of per capita tax levels and (d) 10 per cent to take account of special problems.8/

Table 2: Tax sharing and Article 275 gap grants under Finance Commissions

Finance Commission (Award Period)		Tax sharing			Art.275 gap grants (Rs. crores)	Total Devolution (Rs. crores)	Proportion of gap grants in total devolution (per cent)
		Art.270 (Rs. crores)	Art.272 (Rs. crores)	Total (Rs. crores)			
First	(1952-57)	284	82	366	27	393	6.9
Second	(1957-62)	410	176	586	185	771	24.0
Third	(1962-66)	461	357	818	252	1070	23.6
Fourth	(1966-69)	507	628	1135	423	1558	27.2
Fifth	(1969-74)	2138	1850	3988	713	4701	15.2
Sixth	(1974-79)	3274	3705	6979	2683	9662	27.8
Seventh	(1979-84)	5191	13630	18821	1627	20448	8.0
Eighth	(1984-89)	NA	NA	31166	2200	33366	6.6

Source: Figures upto 1983-84 have been re-tabulated from Appendix IV (pp. 156-157) in the Report of the Eighth Finance Commission 1984. Figures for 1984-89 are estimates derived from Table 9 (p.96) of the same report.

The plan transfer criteria are thus an amalgam of diverse and sometimes conflicting considerations. Special needs arising from hill areas, tribal populations and a low resource base (as in the special category States) are taken into account. A premium is given to States which happen to implement externally-aided projects. A large weight is given to the uniform scaling factor of population. While the per capita income criterion favours the poorer States, the tax effort criterion helps relatively richer States who have been able to achieve higher tax receipt levels per capita.

Combined impact of transfer criteria

Analytically, it is difficult to evaluate the resultant effect of criteria used in plan transfers; much more so, the combined effect of the criteria involved in Finance Commission and in plan transfers. Table 3 shows for 14 major States on a per capita basis, plan sizes and plan assistance for 1980-85 alongside transfers under the VII Finance Commission for 1979-84. The States have been listed in descending order of per capita income in 1976-79. It will be seen that the richer States tend to claim larger plan outlays. The rank correlation coefficient between States ranked in ascending order of per capita income (lowest to highest) and the ranking of their per capita plan outlays (highest to lowest) is strongly inverse with the coefficient being minus 0.70. In other words, as will be plainly visible from the Table, plan sizes become smaller as States get poorer. Plan assistance is redistributive but only mildly so with the rank correlation coefficient between ranks according to per capita income (lowest to highest) and per capita plan transfers (highest to lowest) being + 0.34. Finance Commission transfers are, however, strongly redistributive with the corresponding rank correlation coefficient being + 0.81.

Table 3: Plan outlay, Plan assistance and Devolution

State[1/]	Approved plan outlay 1980-85[2/] (Rs. per capita)	Central plan assistance 1980-85[3/] (Rs. per capita)	Devolution from VII Finance Commission[4/] 1979-84 (Rs.per capita)
1. Punjab	1165.6	178.7	164.4
2. Haryana	1393.0	181.7	176.0
3. Maharashtra	983.5	139.5	209.4
4. Gujarat	1079.6	175.9	227.1
5. W.Bengal	641.3	124.6	245.5
6. Karnataka	609.9	145.2	226.6
7. Tamilnadu	650.7	137.3	267.6
8. Kerala	608.9	169.0	263.2
9. Rajasthan	591.0	182.8	228.4
10. Andhra Pradesh	578.9	179.1	242.9
11. Orissa	568.8	250.1	331.4
12. Madhya Pradesh	728.3	194.2	266.7
13. Uttar Pradesh	527.7	174.0	263.2
14. Bihar	461.3	180.3	287.2
All major States (Average)	678.0	175.2	249.8

1/ Assam is not included as it has been dealt with as a "special category" State by the Planning Commission.

2/ Derived from Annexure 4.1 (p.56) in Sixth Five Year Plan 1980-85.

3/ Planning Commission data

4/ Derived from data in Report of the Finance Commission 1978.

Note: 1981 population figures have been used to work out per capita figures.

Working of the Criteria : Summing up

We shall conclude our review of the transfer process by underlining two main points:

(a) Under the division of labour that has come to be established between them and the Planning Commission, Finance Commissions have necessarily had to cover assessed gaps on the non-plan revenue account for the quinquennial period covered by their award. In the short-term this is inevitable as the decks will have to be cleared for plan financing. However, a willingness to fill gaps whenever, wherever, for whatever reasons, and to the extent they emerge amounts to an absence of policy. It undermines fiscal responsibility and is inequitable *inter-se* between the States. A long term approach would in these circumstances entail the identification of the causal factors leading to "gaps" and the evolution of a policy for devolution which would over time ensure that non-plan gaps are closed, as far as possible on the basis of tax-sharing on settled principles, retaining Article 275 grants to meet exceptional need. Manifestly, this is the spirit of the sequence and wording of Articles 270, 272 and 275.

Successive Finance Commissions have noticeably failed to evolve such a policy in the absence of which it has not been possible to arrive at a rationale for the determination of the inter-related parameters that govern Finance Commission devolutions viz., (a) the quantum of vertical devolution (b) its division between tax-sharing and Article 275 grants and (c) the principles for horizontal tax-sharing.

(b) There has been no attempt to coordinate the devolution criteria of Finance Commissions with the formulae on which plan assistance is based. Devolution is the first step in the chain of resource accumulation for State Plans. It has been redistributive, favouring the poorer States; plan assistance has been

significantly less redistributive; and the final outcome viz., the plan size is heavily weighted in favour of the richer States. This phenomenon might well lead to richer States having larger non-plan gaps in the subsequent quinquennium, claiming a greater share in devolution.

II

General considerations for evolving policy

Proceeding from this critique, some general considerations which might help to evolve a long-term policy for non-plan and plan transfers could be outlined. At the outset, it must be appreciated that the basic rationale of devolution has to be redistributive : it is a process of re-cycling resources from where they accrue to where they might be needed. The Grand Maxim of redistribution is : "From each according to ability, to each according to need". This implies that the transfer process while being 'need-based' should also seek concurrently to improve the 'ability' to meet needs. In other words, it should be such as to promote an increase in the size of the cake while slicing it.

The first slice of the cake is the vertical sharing between the Centre and the States as a group. While recognising the politics of Centre vs States in fiscal relations, we must not forget that functionally the Centre represents the States-in-Union. In principle, its functions are not rival, but complementary and supportive, to those of the States. Successive Finance Commissions, notably the Seventh, have secured an increase to the States' share in the national pool of resources. States have urged that the shareable base of taxes should be enlarged with the addition of corporate taxes and even customs duties to it. The operative issue however is not what can be shared but how much of it. Here it can not be presumed that the long-term developmental or

non-developmental responsibilities of the Union are likely to take second precedence to those of the States, enabling significant progressive increases to the share of the latter. In this context, it is clearly necessary for the States to more fully exploit their tax potential, ensure better tax collections, obtain improved returns from their investments, and conserve revenues instead of giving them away for short-term political popularity. The 'ability' part of the redistribution maxim requires that progress must be promoted on such lines.

In correlating ability and needs, it is necessary and possible to make a sufficient distinction between economic backwardness and fiscal inadequacy. It is possible for States to be fiscally weak while being relatively advanced in economic potential; and for States at about the same level of economic backwardness to display varying levels of fiscal effort. Following from this, the attempt should be for Finance Commissions and the Planning Commission to delimit and coordinate their operations in such a manner that while needs arising from economic backwardness are responded to, fiscal ability is concurrently upgraded consistent with the potential for it at varying levels of development in individual States.

In order to evolve a concrete formula, it is necessary to add a couple of practical considerations. Firstly, Finance Commissions will need to be clear about what they can, and can not, do in practice. By definition, revenue gaps arise from an excess of expenditures over revenues; they can be reduced only by limiting expenditures and/or increasing revenues, tax and non-tax. On the expenditure side, all that Finance Commissions have been able to attempt is the harmonisation of maintenance provisions and emoluments. Non-tax revenues have been sought to be improved by prescribing normative returns on investments while assessing the revenue gap. Beyond this,

Finance Commissions have not been in a position to seek improvements in economy or efficiency in fiscal management. This is understandable as they can not transform themselves into an Expenditure Commission laying down standards for salaries, levels of services, cost-effectiveness etc. under widely varying conditions in individual States. Some effort to do this through specific indicators of backwardness has proved to be a dead-end. Any such approach also amounts in principle to an encroachment on the functions of the Planning Commission. The lesson to be drawn from all this is that in any long-term effort to minimise revenue gaps, the Finance Commission operation will have to concentrate on upgrading tax revenues which constitute over three-quarters of total revenues in the States and are the main component of the 'ability' side of the equation.

The second set of practical considerations consist in the requirement that devolution criteria should be simple and based on data that would be considered reliable. As the VIII Finance Commission has observed "three over-riding considerations were emphasised by all the experts and disinterested observes we met. These considerations are (i) that the formula should be progressive in the sense that it should allocate a larger share to those States which have relatively lower incomes, or, which are otherwise backward and financially weak; and (ii) the formula should be simple and (iii) firm and reliable data should be available for applying the formula".[9/]

Taxonomy of States

It will be instructive at this point to look at the VIII Finance Commission's assessed gaps for 1984-89 in each of the 15 major States. Table 4 gives the figures and shows also the components in terms of revenue and expenditure that have contributed to the surplus or gap in each State. The States have been arranged in descending order of average per capita incomes

in 1976-79 (which is the basis for comparison adopted by the Commission) i.e., from the richest to the poorest. The table shows that the major States can be grouped into the following broad categories:

(A) Six States vis., Punjab, Haryana, Maharashtra, Gujarat, Karnataka and Tamilnadu do not have any non-plan revenue gaps. They enjoy revenue surpluses prior to devolution. These States are relatively advanced. Both per capita revenues and expenditures are above the major-States' average with revenues being higher than expenditure so as to yield surpluses.

(B) West Bengal is also a relatively advanced State with a per capita income that is higher than those of Karnataka and Tamilnadu in Category (A). However, it shows a large initial non-plan revenue gap which arises from a low per capita revenue and high per capita expenditures. The per capita revenue of West Bengal is lower than the 15-States average while its per capita expenditure is higher than the corresponding average.

(C) Kerala and Andhra Pradesh are relatively poor States. Their per capita revenues are higher than average but per capita expenditures even more so, resulting in deficits.

(D) The six other major States with deficits are Rajasthan, Assam, Orissa, Madhya Pradesh, Uttar Pradesh and Bihar. They are among the poorest States. In their case, both per capita revenues and expenditures are lower than average but the former more than the latter leading to deficits.

The taxonomy that emerges can be summed up. Category (A) States are relatively advanced. They have relatively high revenues as well as expenditures and manage to earn more than they spend. All the other nine States spend more than they earn. West Bengal, despite being an advanced State, has

Table 4: Per capita revenues, non-plan expenditures and surplus or gap, 1984-89

(Rs.)

State	Per capita income 1976-79 (average)	Per capita tax revenue 1984-89	Per capita non-tax revenue 1984-89	Per capita total revenue 1984-89 1/	Per capita non-plan revenue expenditure 1984-89	Per capita non-plan revenue surplus (+) or deficit (-) 1984-89
1	2	3	4	5	6	7
1. Punjab	2250	445.91	123.78	589.98	453.28	+136.70
2. Haryana	1895	424.66	136.93	575.17	425.67	+149.50
3. Maharashtra	1670	393.16	99.83	500.37	379.62	+120.75
4. Gujarat	1590	347.11	52.80	397.34	336.36	+ 60.68
5. W. Bengal	1247	178.10	58.04	237.30	348.49	-111.19
6. Karnataka	1202	267.22	76.17	352.14	330.20	+ 18.94
7. Tamilnadu	1165	320.21	51.64	381.58	349.60	+ 31.98
8. Kerala	1162	267.35	68.32	332.00	381.93	- 49.93
9. Rajasthan	1127	164.14	52.96	223.47	295.89	- 72.42
10. Andhra Pradesh	1006	244.80	51.32	296.88	328.47	- 31.59
11. Assam	960	78.37	60.72	142.93	288.13	-145.20
12. Orissa	918	104.78	56.93	168.31	294.50	-126.19
13. Madhya Pradesh	895	152.57	102.02	256.29	287.02	- 30.73
14. Uttar Pradesh	870	126.81	42.48	169.75	207.88	- 38.13
15. Bihar	755	80.51	46.56	129.68	219.86	- 90.18
All 15 States Average	1140	215.63	64.79	284.18	305.02	

1/ In view of minor adjustments, figures in columns (3) and (4) will not add up to those in column (5).

Source: Based on data in Report of the Eighth Finance Commission 1984 Appendix VI (for per capita income) and Annexure III-27 for State-wise figures. Per capita figures are based on 1981 population.

relatively low earnings while Kerala and Andhra Pradesh, despite being poor, have relatively high earnings. Rajasthan, Assam, Orissa, Madhya Pradesh, Uttar Pradesh and Bihar are both poor and poor earners.

Table 4 also brings out some other features of interest. On the revenue side, it is tax revenues that account for the bulk viz., 76 per cent on the average in the major States. The variation of per capita tax revenues among the States is high, the coefficient of variation being 0.50. Non-tax revenues, the principal items of which are interest, dividends and forest revenue, vary within a lower margin, the coefficient of variation in their case being 0.40. The variation in per capita non-plan revenue expenditure is the least, the relevant coefficient in this case being 0.20. These features corroborate that the key determinant that accounts for surpluses or deficits is the level of per capita tax revenue and that any scheme that aims to promote better fiscal balance in the States would mainly have to operate on the tax revenue parameter.

We shall now examine the association between per capita tax revenue and per capita income in these States. Table 5 shows per capita incomes, per capita tax revenue, and the tax-income ratio (TIR) viz., the ratio of the latter to the former for the 15 major States. The States are ranked in the Table in descending order of per capita incomes (i.e. from the richest to the poorest). The close association between per capita tax revenue and per capita income is quite visible. The rank correlation coefficient between the two is as high as 0.90. In other words, the economically richer States tend to have relatively high per capita tax revenues. This is not surprising since plausibly States with higher per capita incomes also have a better taxable potential.

Table 5: Per capita incomes and per capita tax revenue

State	Per capita income 1976-79 Average (Rs.)	Per capita tax revenue 1984-89 Average (Rs.)	Tax-income Ratio
(1)	(2)	(3)	(4) = (3)/(2)
1. Punjab	2250	445.91	0.1982
2. Haryana	1895	424.66	0.2241
3. Maharashtra	1670	393.16	0.2354
4. Gujarat	1590	347.11	0.2183
5. W.Bengal	1247	178.10	0.1428
6. Karnataka	1202	267.22	0.2223
7. Tamilnadu	1165	320.21	0.2748
8. Kerala	1162	267.35	0.2300
9. Rajasthan	1127	164.14	0.1456
10. Andhra Pradesh	1006	244.80	0.2433
11. Assam	960	78.37	0.0816
12. Orissa	918	104.78	0.1141
13. Madhya Pradesh	895	152.57	0.1705
14. Uttar Pradesh	870	126.81	0.1458
15. Bihar	755	80.51	0.1066
All 15 States Average	1140	215.63	0.1891

Source: Same as for Table 4.

The association between per capita income and the TIR is not so strong, the relevant rank correlation coefficient being only 0.49. The average TIR for all 15 major States is 0.19. As many as eight States have registered TIRs above this figure; they range all the way from Punjab with a per capita income of Rs.2250 to Andhra Pradesh with a per capita income of Rs.1006s. The other seven States with below-average TIRs range from W.Bengal, a relatively advanced State to Bihar the poorest. TIRs in their case vary widely from 0.08 (Assam) to 0.17 (Madhya Pradesh).

The actual level of per capita tax revenue in any State can be viewed as a product of its tax potential and its effort in exploiting this potential i.e. its tax effort. The tax potential would be a function not only of per capita income (i.e. average prosperity) but also of structural features such as the sectoral distribution of the SDP, income distribution, urbanisation, habits relating to entertainment, consumption of liquor and so on. On its part, the tax effort would be reflected in the coverage of taxes, the rates of taxation, efficiency of collection, the extent of concessions and loopholes and so on. Ideally, the tax effort would have to be measured by relating tax realisations to the tax potential. To do so, we will first have to estimate the tax potential of each State. Unfortunately, an unambiguous and generally acceptable methodology for the estimation of tax potential is not available.10/ In its absence, we will have to be content with the measure of the extent to which incomes have been actually captured as taxes. This is the tax income ratio (TIR). It is a measure of tax performance. To the extent that SDP is a surrogate for tax potential, it can also be taken as a first-information indicator of tax effort; no more than that but nevertheless the best that is available and usable.

III

The proposed procedure

We can now move on to outline a procedure that can be expected to promote the long term considerations discussed earlier. As the first step in the procedure, we would suggest that shares to States in taxes under Articles 270 and 272 should be allocated according to a formula which seeks to compensate for poverty as reflected in per capita incomes but in keeping with, i.e. weighted by, the tax performance ratio i.e. the TIR. This can be done by working out a Tax Adjustment Weight (TAW) for each State. The TAW for the ith State will be the product of its population (P_i), the distance of its per capita income (y_i) from that of the State with the highest per capita income (y_m) and its tax income ratio (t_i/y_i). Algebraically, TAW = $P_i \times (y_m - y_i) \times t_i/y_i$.

The logic and merits of this formula should be easy to see. The TAW quantum will be related to both the per capita distance viz., ($y_m - y_i$) and the extent of tax performance viz., t_i/y_i. Poorer States for whom ($y_m - y_i$) is large will be benefited. At the same time, an incentive will be built-in for States to achieve better tax performance i.e. higher t_i/y_i ratios. By definition, the TAW will be zero for the State with the highest per capita income viz., where $y_i = y_m$. If it is felt that no State should be altogether left out of tax sharing, the formula will have to be slightly moderated. This can reasonably be done by allowing to the State with the highest per capita income, the same 'distance' as that for the second richest State. This modification is the same as that adopted by the VIII Finance Commission in applying its distance criterion. Table 6 gives the Tax Adjustment Weights on this basis for the major States using the estimates in the VIII Finance Commission's report.

Table 6 : Tax Adjustment Weights

State	1981 population (crores)	Per capita income Distance	Tax-Income Ratio 2/	TAW
(1)	(2)	(3)	(4)	(5) =(2) x(3) x(4)
1. Punjab	1.6789	355 3/	0.1982	118.1291
2. Haryana	1.2922	355	0.2241	102.8016
3. Maharashtra	6.2784	580	0.2354	857.2025
4. Gujarat	3.4086	660	0.2183	491.1043
5. W.Bengal	5.4580	1003	0.1428	781.7406
6. Karnataka	3.7136	1048	0.2223	865.1589
7. Tamilnadu	4.8408	1085	0.2748	1443.3232
8. Kerala	2.5454	1088	0.2300	636.9609
9. Rajasthan	3.4262	1123	0.1456	560.2139
10. Andhra Pradesh	5.3550	1244	0.2433	1620.7721
11. Assam	1.9897	1290	0.0816	209.4438
12. Orissa	2.6370	1332	0.1141	400.7744
13. Madhya Pradesh	5.2179	1335	0.1705	1187.6853
14. Uttar Pradesh	11.0862	1380	0.1458	2230.5877
15. Bihar	6.9915	1495	0.1066	1114.2143
Total	65.9194			12620.1120
Average		1140	0.1891	

1/ See Table 5 for per capita incomes. Figures are distances from Rs.2250 which is the highest per capita income for any State (per capita income of Punjab). See also note 3/.

2/ As given earlier in Table 5.

3/ Assumed at same level for Haryana.

The data required for implementing the formula is the same as what has been used by successive Finance Commissions viz., population, SDP and tax revenue projections for the award period. Not all these parameters may relate to the same year or to an identical period; for instance, the population figures available to the Eighth Finance Commission related to 1981 and the per capita income figures used by them were averages for 1976-79. Such non-synchronization will not however be a serious shortcoming since we are concerned only with proportions.

The formula does not constitute any violent departure from the concerns and practices of Finance Commissions. The very first Finance Commission had the following to say on tax effort as a criterion for devolution:-[11/]

> "The extent of self-help of a State should determine the eligibility for, as well as the amount of, help from the Centre. This requires an assessment of the general scope for additional taxation in the States and of their tax effort. The point may be made that differences in relative taxation from State to State are of no relevance for the purpose of determining the degree of Central assistance to various States, as such assistance should be based primarily on the comparative poverty or affluence of the States as judged by indices of their relative per capita incomes. This argument seems to miss the rationale of taking the relative tax effort of States into consideration. A State which is prepared to raise the maximum amount of revenue through taxation is better entitled to Central assistance than a State which does not itself act sufficiently in the same direction. In respect of a State in the latter class, there is no guarantee that the benefit of external assistance will, in fact, accrue to the weaker sections of the community for whom it would be intended. Assistance to such a State may have the effect of postponing action by the State to increase its own taxation. Such assistance from outside may thus go to relieve those who are comparatively well off from the necessity of contributing more to State revenues rather than help to increase public expenditure for the benefit of the general mass of the people. It may be observed that it is only in clear cases of inadequate taxation that this should affect the quantum of assistance a State would otherwise be qualified to get."

Its wisdom on the subject however fell by the wayside for two main reasons. The First Commission viewed tax effort as a principle for determining Article 275 grants instead of tax sharing. The division of labour that subsequently came about between Finance Commissions and the Planning Commission resulted in a situation where Article 275 grants were required to be used for residuary gap-filling; they could no longer be used as a deliberate policy instrument. Secondly, the well known difficulties in arriving at a true measure of tax effort inhibited any approach that could give due weight to this early and important consideration. The VII Finance Commission through the revenue equalisation formula made an attempt to introduce tax effort as a criterion in excise-sharing but its intention got miscarried because of the particular formula chosen. As far as the redistributive element in tax-sharing is concerned, Finance Commissions have meanwhile moved to the use of aggregate indicators related to State per capita incomes, which began to be available on a comparable basis since the early 1970s. Among these, the distance criterion has been used since the VI Finance Commission (1973) and has been given the preponderant place by the VIII Commission (1984) which has given it a weight of 50 per cent in its main tax sharing formula. Moreover, the VIII Commission has admirably broken with tradition in using basically the same formula for income taxes and for excise. The proposed TAW formula only crystallises these lines of evolution by compounding the tax performance and the distance criterion, and in applying it to tax sharing in its entirely. We may also add that the TIR is a tax performance indicator which we have been forced to adopt in the absence of an adequate and acceptable indicator of tax effort. If, in course of time, one such becomes available, it could be substituted for the TIR in the formula without disturbing the basic rationale.

The TAW can only determine proportionate, or horizontal, transfers to the States. For our present purpose, we shall assume that the vertical sharing of taxes for the 15 major States is at the level recommended by the VIII Finance Commission and, on this basis, illustrate how the TAW formula will operate. Thereafter, we shall discuss how a long term policy for devolution, which includes vertical and horizontal tax sharing and Article 275 grants, could be built around the formula.

The VIII Finance Commission has used an amount of Rs. 28,707.50 crores for tax sharing under Articles 270 and 272 to the 15 major States, this sum being the share of these States, on the basis of the formulae adopted by the Commission, in 85 per cent of net proceeds from income taxes and in 45 per cent of Union excise duties.[12/] Table 7 works out the distribution of this given sum by way of tax sharing and residuary gaps under Article 275.[13/] Consistent with the arithmetic involved, the tax sharing component of devolution has been arrived at by multiplying the TAW quantities for each State by a uniform factor of 2.02 with a minor adjustment being made in the case of the State with the highest per capita income (viz., Punjab) on the lines already indicated. Table 7 also shows the devolution made by the VIII Finance Commission for purposes of comparison.

The table will help to clarify the differentiation that emerges from the TAW formula in the quantum and components of devolution in our scheme <u>vis-a-vis</u> under the VIII Finance Commission. The top four States viz., Punjab, Haryana, Maharashtra and Gujarat obtain lesser amounts in our scheme than under the VIII Commission. Four less advanced States which have shown a good tax performance viz., Karnataka, Tamilnadu, Kerala and Andhra Pradesh are -- not undeservedly -- benefited. Four distinctly poor States with low tax performance ratios viz., Rajasthan, Madhya Pradesh, Uttar Pradesh and Bihar

Table 7: Devolution proposed and under VIII Commission

State	Under proposed formula			Under VIII Finance Commission		
	Tax sharing under Art. 270 & Art. 272	Art 275 gap grants	Total Devolution	Tax sharing under Art. 270 & Art. 272	Art 275 gap grants 1/	Total Devolution
1. Punjab	238.62	--	238.62	444.18	--	444.18
2. Haryana	207.66	--	207.66	318.67	--	318.67
3. Maharashtra	1731.55	--	1731.55	2079.47	--	2079.47
4. Gujarat	992.03	--	992.03	1145.37	--	1145.37
5. W.Bengal	1579.12	1068.87	2647.99	2434.28	233.91	2668.19
6. Karnataka	1747.62	--	1747.62	1471.90	--	1471.90
7. Tamilnadu	2915.51	--	2915.51	2106.54	--	2106.54
8. Kerala	1286.66	--	1286.66	1083.65	--	1083.65
9. Rajasthan	1131.63	--	1131.63	1319.94	10.19	1330.13
10. Andhra Pradesh	3273.96	--	3273.96	2414.99	--	2414.99
11. Assam	423.08	908.02	1331.10	1138.31	215.48	1353.79
12. Orissa	809.56	699.08	1508.64	1406.44	111.70	1518.14
13. Madhya Pradesh	2399.12	--	2399.12	2479.73	--	2479.73
14. Uttar Pradesh	4505.79	--	4505.79	5252.08	--	5252.08
15. Bihar	2250.71	507.92	2758.63	3611.95	--	3611.95
	25492.62	3183.89	28676.51	28707.50	571.28	29278.78

1/ Excludes Article 275 grants for upgradation of standards and for improvements to emoluments.

get less under the proposed formula than under the VIII Commission. However, even without Article 275 grants, tax sharing is adequate to cover their gaps except in the case of Bihar. Under both schemes, Article 275 grants are needed for Assam, Orissa and Bengal. As such, devolution to these States work out to about the same figure in both schemes. A small revenue gap grant is required for Rajasthan under the VIII Commission; in our scheme it is not. Bihar requires a gap grant in our scheme while under the VIII Commission its gap gets fully covered by tax sharing. There are thus only marginal differences in the number of States requiring Article 275 grants under both schemes. The proportion of Article 275 grants in total devolution is 11 per cent in our proposal while it is only 2 per cent for the major States under the VIII Commission. However, in the light of past trends (vide Table 2) 11 per cent can not be considered prima facie too high a price to be paid for a logical differentiation.

Elements of policy

The real value of the TAW-based scheme of devolution is that it helps in producing some guidelines for a long term approach or policy. It reduces post-devolution surpluses in the richest four States and increases them for four States who are both relatively poor and have shown a relatively good tax performance. Surpluses are available, although at a reduced level, for a set of poor States with relatively low tax effort. In their case, larger plan assistance will be required for meeting incremental development needs; at the same time, such States would have to be encouraged and assisted to improve their tax performance ratio. The formula identifies four other States viz., W.Bengal, Assam, Orissa and Bihar which, because of particularly low tax income ratios, are in need of gap grants even after due compensation has been made with reference to their per capita incomes. These States, over a period of time, will have to be graduated into a position where they too could get their gaps covered through tax sharing.

Let us see if the graduation involved would be prima facie feasible. We can work out the levels of the tax income ratio at which the four States with post tax sharing deficits could have avoided the need for Article 275 grants with devolution being as suggested in our formula. The arithmetic involved is simple.[14/] It shows that W.Bengal would have had to improve its TIR from 0.14 to 0.20, Assam from 0.08 to 0.21, Orissa from 0.11 to 0.19 and Bihar from 0.11 to 0.13. The improvement required in the case of W.Bengal does not seem infeasible when we find that the average TIR for the major States is 0.19 (vide Table 5) and that as many as four States with a lower per capita income than W.Bengal have achieved TIRs ranging from 0.22 to 0.27 (viz., Karnataka, Tamilnadu, Kerala and Andhra Pradesh). The improved performance required in the case of Bihar, from 0.11 to 0.13, is marginal and would appear to be not too difficult of realisation. Assam and Orissa would have had a relatively long way to go but refer to Madhya Pradesh which, while being poorer than both, has registered a TIR of 0.17.

The long term policy, in these circumstances, could be to say that given reasonable vertical tax sharing and its distribution on the TAW principle, no major State should as a matter of course expect Article 275 grants for gap-filling purposes. Adequate time for adjustment, i.e. for achieving fiscal balance, should however be provided to States who are, so to speak, in the red at the time of instituting the policy. For instance, if the VIII Finance Commission had adopted the policy, W.Bengal and Bihar could be notified that they will not be eligible for gap grants in the subsequent quinquennium of 1989-94. Assam and Orissa may need more time but they too may qualify for graduation in due course. In this way, Finance Commissions can liberate themselves from the gap-filling syndrome into which they have willy-nilly fallen.

This does not mean that Article 275 grants will not be used at all; only that they will be deployed on deliberate policy considerations and not as a mere residuary instrument for gap-filling. Primarily, grants-in-aid will be required for the smaller States which are also "hill" and border States: Himachal Pradesh, Jammu and Kashmir, Manipur, Meghalaya, Nagaland, Sikkim and Tripura. They have special needs arising from a low revenue base and high expenditure requirements. If Assam can not be graduated within a reasonable period, it too might have to be added to this set of States. Secondly, Article 275 grants will be needed, as hitherto, for providing specific purpose assistance to the poorer States for the upgradation of maintenance and other administrative outlays which come under non-plan expenditure heads.

We may now explore ways in which Central assistance for the Plan can complement and carry forward the long term approach which has been outlined for Finance Commissions. We have already shown that plan outlays i.e. the size of the Plan is distinctly regressive (vide Table 3). This is not surprising. The Plan size is the outcome of (a) post Finance Commission surpluses (b) additional resources raised by the States for the Plan (c) net market borrowings for the Plan and (d) Central plan assistance. The advanced States start with higher initial surpluses on account of (a); they are in a position to raise relatively more resources under both (b) and (c); and, as we have seen, the plan assistance formula under (d) is not sufficiently redistributive. Moreover, the grant proportion in Central plan assistance is a uniform 30 per cent of the total which does not differentiate between States according to needs.

It is beyond the scope of this paper to develop an alternative formula for the whole of plan assistance, which includes loans for capital investments. Our primary concern is with the

revenue component of the Plan and the grant component of Central plan assistance as it is to them that the operations of the Finance Commission are linked. The two suggestions that could be made, in the light of our analysis, are that the plan revenue component for each State should be determined in a need-based manner with reference to outlays required in the social and welfare sectors such as education, health and family planning, housing, water supply etc; and that Central grants for these outlays should be reasonably linked to the State's own effort at raising revenues. For the latter purpose, the distance criterion in the TAW formula could be logically used. I.e., the Central plan grant could be so worked out that it would supplement every rupee of tax raised by the State by an amount related to the distance criterion viz., $(y_m - y_i)/y_i$. Factors worked out on this basis with reference to the per capita income figures in the VIII Finance Commission's report are given in Table 8. Such a supplementation procedure will positively discriminate in favour of the poorer States. At the same time, it will provide all States with some incentive for additional resource mobilisation. An upgradation of the tax performance through such incentives will reduce non-plan gaps in the subsequent Finance Commission quinquennium.

Another value of the TAW formula is that it draws attention to the tax performance ratio in each State. Additional taxation targets for the Plan could be fixed with reference to them so as to upgrade reasonably this ratio in lagging States, particularly those which were in need of gap grants at the beginning of the Plan period.

Politically, the overall quantum of transfers from the Centre is a matter of prime concern to the States. At any level of it, the modality of such transfers viz., via devolution or under the plan will remain an issue as also the related

Table 8: Additional-tax supplementation factors

State	Per capita income 1976-79 Average	Distance	Supplementation Factor
(1)	(2)	(3)	(4) = (3) ÷ (2)
1. Punjab	2250	355 1/	.1578
2. Haryana	1895	355	.1873
3. Maharashtra	1670	580	.3473
4. Gujarat	1590	660	.4151
5. W.Bengal	1247	1003	.8043
6. Karnataka	1202	1048	.8719
7. Tamilnadu	1165	1085	.9313
8. Kerala	1162	1088	.9363
9. Rajasthan	1127	1123	.9965
10. Andhra Pradesh	1006	1244	1.2366
11. Assam	960	1290	1.3438
12. Orissa	918	1332	1.4510
13. Madhya Pradesh	895	1335	1.4916
14. Uttar Pradesh	870	1380	1.5862
15. Bihar	755	1495	1.9801

1/ Assumed at same level for Haryana

one of enlarging the shareable base under devolution with the inclusion of corporation taxes, if not custom duties as well. In the absence of Constitutional guidelines for the extent of tax sharing, it has been left to the liberality or otherwise of "five persons or a majority of them" in various Finance Commissions to determine the vertical sharing under their auspices. Primacy to devolution in the overall transfer process does not in itself increase the quantum of overall transfers; it only produces larger initial surpluses for plan financing. Thereby, the Planning Commission's scope for fixing Plan outlays in a progressive and need-based manner, which can favour the relatively backward States, gets curtailed. It will therefore be desirable to have a logical basis for deriving vertical devolution; in fact, this is necessary if graduation in the way in which we have outlined it is to have meaning. The TAW quantities can help to indicate such a basis. In illustrating the formula with reference to the VIII Finance Commission's award, we found that tax sharing worked to about twice the sum of the TAWs for the major States. As a matter of long term policy, some such suitable multiple could be fixed and the proportion of taxes to be shared derived from it.

The strength of the Indian Centre-State fiscal system is that it provides mechanisms in the Finance and Planning Commissions which can redistribute national resources between the Centre and the States and amongst the latter in the light of the twin considerations of ability and need. The weakness has been that in the historical working of the two Commissions there has been a lack of both clarity and coordination in regard to operative ways in which each of the Commissions could address itself to upgrading ability while responding to needs and, concurrently and conversely, compensate for backwardness while upgrading ability. The kind of approach we have outlined seeks to sort out this problem. Under it, the Finance Commissions and the Planning Commission, whose exercises in Centre-

State transfers chronologically succeed each other, can also logically work in tandem. I.e., etymologically,"like horses in harness, one behind another".

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1/ Report of the Finance Commission 1965 pp.92-93.

2/ Report of the Finance Commission 1984 (pp.122-123). points out how the two periods have become de-synchronised in the award periods for 1979-84 and 1984-89 and has recommended that "the period covered by the recommendations of the Finance Commission should be synchronized with that of the Five Year Plan and that this may be kept in view while constituting the next Commission."

3/ The Fourth Finance Commission crystallised this division of responsibility in the following passage in its Report (pp 8-9):

"When the provisions regarding the Union-State financial relations were incorporated into the Constitution, it was not possible for any one to anticipate the importance and magnitude of our successive Five Year Plans. There was no reference to Plan expenditure as such in the terms of reference of the First Finance Commission (November 1951 - December 1952) and that body did not find it necessary to draw a line of distinction between plan and non-plan expenditure. In fact, it emphasised the need for taking into account development expenditure of various types in determining the transfer of resources from the Centre to the States. The Second Finance Commission (June 1956 - September 1957) was, however, specifically asked to take into account both the requirements of the Second Five Year Plan and the efforts made by States to raise additional resources... The Third Finance Commission (December 1960 - December 1961) recommended grants under Article 275 to cover 75 per cent of the States revenue expenditure on the Third plan but the Government of India did not accept this recommendation.

The term of reference of the Fourth Finance Commission do not expressly mention Plan expenditure.... The Constitution does not make any distinction between Plan and non-Plan expenditures and it is not unconstitutional for the Finance Commission to go into the

whole question of the total revenue expenditure of the States..... It is, however, necessary to note that the importance of planned economic development is so great and its implementation so essential that there should not be any division of responsibility in regard to any element of Plan expenditure. The Planning Commission has been specially constituted for advising the Government of India and the State Governments in this regard. It would not be appropriate for the Finance Commission to take upon itself the task of dealing with the States' new plan expenditure".

4/ After reveiewing a list of such indicators which had been used by previous Commissions, the Sixth Finance Commission rejected this approach on three grounds: (i) given a high degree of correlation among the several possible indicators, if all or a sub-set of them were to be used, the effect will be compounded (ii) the use of indicators related to backwardness in social services (e.g. school enrolment, hospital bed strength) will prejudice States which, despite a poor resource base, have achieved relatively high levels of attainment in these sectors and (iii) the assignment of weights to the different indicators was "an intractable issue". See Report of the Finance Commission 1973 (p.16). These views were endorsed by the Seventh Commission in their Report (1978), p.86.

5/ The formula allocated shares on the basis of the distance between a State's revenue (R_i) from that of the State (R_m) with the highest per capita income (y_m). Revenue in both cases was derived from the linear regression formula $R = a + b.y$. Thus $R_m = a + b.y_m$ and $R_i = a + b.y_i$. The equalisation amount viz., $R_m - R_i$ will therefore boil down to $b\ (y_m - y_i)$ or the per capita distance criterion. The point has been succintly recognized in the Report of the Eighth Finance Commission 1984 (para 6.35 p.51): "with a linear equation, when only one independent variable viz., per capita income has been used, the revenue equalisation formula did not amount to anything different from allocating shares in revenues to States based on the distance of the per capita income of the State from the highest per capita income of any State".

6/ The use of differential criteria for income taxes and for excise had been justified by earlier Finance Commissions on legalistic arguments. They hinge on the fact that under Article 270 of the Constitution income taxes "have to be shared"; as such the view has been taken that each State has an entitlement to it based on uniform principles. On the other hand, excise duties in the language of Article 272 "may be shared" which discretionary phrasing has been construed as permitting a redistributive approach to excise transfers. There is, of course, no basis for this differentiation in economic logic. Prof. Raj Krishna in addition questioned the legal persuasiveness of this practice in his note of dissent appended to the Report of the Finance Commission 1978 (pp.151-152). In a major innovation, the Eighth Finance Commission has in principle abandoned differential criteria for tax sharing under income taxes and under excise, although it has continued to retain 'contribution' for 10 per cent of income-tax sharing.

7/ Report of the Finance Commission 1952 pp 96-98.

8/ Sixth Five Year Plan 1980-85 p.68.

9/ Report of the Eighth Finance Commission 1984 p.50.

10/ The standard methods available for estimating tax potential are the regression approach and the representative tax system approach. For a discussion of their limitations see Raja J.Chelliah and Narain Sinha The Measurement of Tax Effort of State Governments 1973-76 World Bank Staff Working Papers No.523, 1982. The Eighth Finance Commission considered the possibility of working out a revenue equalisation formula based on the relative taxable capacity and tax effort of States but abandoned it on the ground that any formula in this direction would be "quite complicated" and "the assumptions that might be made in evolving the formula might also be called into question by the States". See Report of the Eighth Finance Commission 1984 pp.51-52.

11/ Report of the Finance Commission 1952 p.96.

12/ The figure has been derived from Table 9 (p.96) and Annexure IV-1 (p.231) of the Report of the Eighth Finance Commission 1984.

13/ The total devolution under the Eighth Finance Commission for the major States under tax sharing and Article 275 gap grants amounts to Rs. 29,278.78 crores. We have however used only the tax sharing component of it, roughly Rs. 28,700 crores, for working out the illustration in Table 7.

14/ The increment required in the TIR for the ith State to cover the Article 275 gap can be obtained by solving for

$$\Delta TIR_i = \frac{G_i}{P_i\,(y_i + 2.02\,d_i)}$$

where ΔTIR_i is the increment in TIR_i, G_i the gap, P_i the population, y_i the per capita income and d_i the per capita income distance.

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